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TAX ADMINISTRATION

IRS' Abusive Tax Shelter Efforts Need Improvement

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The Honorable Lloyd Bentsen
Chairman, Joint Committee on Taxation

The Honorable Dan Rostenkowski
Vice Chairman, Joint Committee on Taxation
Congress of the United States

This report responds to your Committee's request that we examine the Internal Revenue Service's (IRS) and the Department of Justice's efforts to curtail the promotion and sale of abusive tax shelters. The report recommends several actions IRS can take to improve the administration of its efforts against abusive tax shelters. The report also recommends changes for Congress to consider that would allow for easier and more equitable administration of the abusive tax shelter laws.

As arranged with your Committee, we are sending copies of the report to other interested congressional committees and members; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

The Internal Revenue Service's (IRS) inventory of tax returns selected for examination because they contained questionable deductions and credits due to investments in tax shelters rose from about 174,000 cases in fiscal year 1980 to about 285,000 cases by the end of fiscal year 1982. To help keep this inventory from increasing, Congress passed legislation that provided IRS with enforcement tools to curb the promotion of abusive shelters. IRS defines an abusive tax shelter as one utilizing improper or extreme interpretations of the law or facts to secure for investors substantial tax benefits that are clearly disproportionate to the economic reality of the transaction. (See pp. 8 to 10.)

In response to a request from the Joint Committee on Taxation, GAO's review focused on those legislated tools designed to identify and penalize abusive shelter promotions as early as possible, thereby reducing the number of related investor returns entering the examination process. Specifically, this report addresses the effectiveness of IRS' (1) registration and abusive shelter detection programs in identifying abusive tax shelters and (2) administration of the penalties Congress provided to curb the sale and promotion of abusive shelters. (See p. 11.)

Background

Congress passed legislation in 1982 and 1984 authorizing IRS to assess penalties against those who (1) organize, promote, or sell abusive tax shelters; (2) aid and abet others in the understatement of their tax liabilities; and (3) do not register their shelters with IRS or register late. (See pp. 8 and 9.)

With these new compliance tools, IRS established the tax shelter registration program, centralized at its Kansas City Service Center, and the detection team program, located at its 10 service centers. One objective of the programs is to identify and penalize abusive shelters as early as possible, thereby reducing the number of related investor returns entering the examination process. (See pp. 10 to 11.)

Results in Brief

The registration and detection team programs have not been effective in identifying abusive shelters for penalty examinations. The registration program does not provide district examination personnel with enough information with which to decide whether to initiate an examination. The detection team program selection criteria do not provide district personnel with shelter cases that have a high probability of being subject to penalties. (See pp. 14 to 20.)

The penalty that Congress provided IRS to curb the promotion of abusive shelters does not sufficiently reduce the financial incentives for organizing, promoting, and selling abusive shelters. Likewise, the financial disincentive of the penalty for aiding and abetting others in understating their tax liability has been minimized because IRS has difficulty developing the level of proof presently required by law. Also, IRS has been administering the penalties in such a fashion that they were often either overlooked or computed incorrectly. (See pp. 28 thru 35.)

Although the Tax Reform Act of 1986 took away many incentives that made certain types of tax shelters attractive to investors, the impact of the act on future shelters is uncertain. Thus, GAO recommends legislative changes in the penalty structure and improvements in any continued detection programs. (See pp. 9 and 10.)

Principal Findings

Detection Programs Identify Few Abusive Shelters

The registration program identified no abusive tax shelters in the three districts GAO visited. GAO concluded, as did an IRS task force, that the information provided to IRS at registration is not sufficient to attain the program's objective of identifying abusive tax shelters as early as possible. Obtaining the shelter promotional documents that the shelter organizers or promoters provide to potential investors should allow IRS to better determine whether to initiate penalty examinations because these documents contain more information, which could indicate potential abusiveness. (See pp. 14 to 16.)

The detection team program identified one abusive tax shelter in the three districts visited. This program has not been successful in identifying more shelters because the detection teams and IRS' district personnel responsible for initiating penalty examinations use different criteria to identify abusive shelters. Detection team personnel refer cases to district offices based on losses and tax credits claimed on tax returns. In contrast, district personnel use the criteria contained in the law—over 200 percent overvaluation of the asset and/or false or fraudulent statements. As a result, the districts are rejecting many referrals. Unless IRS develops selection criteria that can be used to select cases which district personnel will accept for penalty examinations, the effectiveness of the detection team program will remain questionable. (See pp. 17 to 20.)

Incentive for Promoting Shelters Remains

Congress raised the penalty to deter the promotion and sale of abusive shelters from 10 percent to 20 percent of gross income derived or to be derived. However, GAO found that promoters continue to have a financial incentive for promoting abusive tax shelters. In nine closed shelter cases in three IRS districts GAO visited, promoters were able to retain at least 78 percent of the shelter gross income, which totaled about $54 million. If the Internal Revenue Code provided for a higher penalty, promoters would not have as much financial incentive for promoting abusive tax shelters. (See pp. 28 and 29.)

Incentive for Aiding and Abetting Remains

The law provides that persons who "knowingly" aid and abet another in understating their tax liability are subject to a civil penalty. GAO found in the three districts visited that while IRS assessed the penalty in 5 cases, IRS potentially could have assessed the penalty in 13 more cases if the level of proof required by law had been lowered. IRS officials agree with GAO that changing the language in the Internal Revenue Code to lower the level of proof from knowingly to "knows or reasonably should have known" would enhance the penalty's impact as a financial disincentive because IRS could assess the penalty more often. (See pp. 29 and 30.)

Penalty Oversight and Errors

GAO found that IRS had either overlooked and/or incorrectly computed the penalties in 16 of 29 penalty cases reviewed in three districts. The errors and oversights, which were found in all three districts, amounted to $4.2 million in penalty underassessments. They occurred because (1) national office guidance did not explain how to compute the penalty for organizing, selling, and promoting an abusive shelter when more than one act was committed by the same person; (2) IRS has no internal control procedures to ensure that all appropriate penalties were considered, correctly computed, and assessed; and (3) IRS' national office has no program to ascertain district compliance with national office guidance. (See pp. 30 to 32.)

Recommendations

GAO recommends that Congress amend (1) section 6700 of the Internal Revenue Code to significantly increase the penalty above the current 20 percent of gross income derived or to be derived from the sale of an abusive shelter and (2) section 6701 to lower the level of proof from knowingly to "knows or reasonably should have known" that an understatement of tax liability would result. (See pp. 35 and 36.)

GAO also makes various recommendations to IRS to improve, among other things, the administration of the registration program, detection team program, and district penalty assessment procedures. (See pp. 20, 21, 35, and 36.)

Agency Comments

IRS said overall that although GAO's report provides "many useful comments and recommendations," its implementation of many of the recommended changes should be delayed until the 1986 Tax Reform Act's full impact on shelters has been analyzed. Thus, IRS' position is to generally maintain the status quo in terms of its present programs.

GAO agrees that the act eliminated some incentives for investing in abusive shelters and its full impact is not certain. But it points out that (1) promoters may be able to circumvent some of the Tax Reform Act provisions, (2) history has shown that those who want to abuse the tax system will develop new schemes, and (3) a substantial number of shelters—5,293 in 1987—have registered with IRS since the Tax Reform Act was enacted.

Thus, GAO questions IRS' decision to continue its programs to detect and examine abusive shelters but delay improving those programs. GAO's recommendations are intended to make the programs more efficient and effective. GAO's recommendations are not intended to be cost or labor intensive or difficult to implement. IRS' detailed comments and GAO's assessment are included on pages 21 to 26 and 36 to 38.

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Abbreviations

DRA	Deficit Reduction Act of 1984
IRC	Internal Revenue Code
IRS	Internal Revenue Service
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TRA	Tax Reform Act of 1986

Introduction

Taxpayers have always sought and will continue to seek ways to shelter their income and to reduce their tax liabilities. The demand for tax write-offs and deferrals in the 1970s and 1980s led to the sale and promotion of a variety of tax shelters designed to meet the individual needs of investors. These tax shelters usually led to investors claiming either investment tax credits, energy credits, or both. Eventually, many of these tax shelters involved substantially overvalued or nonexistent assets. Financing of the investment in these shelters often involved nonrecourse notes that the investor was not required to pay. As these types of shelters were detected by the Internal Revenue Service (IRS), they became known as "abusive tax shelters." IRS defines an abusive tax shelter as one "utilizing improper or extreme interpretations of the law or facts to secure for investors substantial tax benefits that are clearly disproportionate to the economic reality of the transaction." Appendix I illustrates how assets in one type of abusive tax shelter can be transferred and overvalued for tax purposes.

By the early 1980s, there was increased concern by both IRS and Congress about the nature of emerging tax shelters and the growing backlog of tax returns with shelter issues in IRS' examination inventory. The inventory of such returns rose from about 174,000 at the end of fiscal year 1980 to about 285,000 by the end of fiscal year 1982. Further, IRS found that the examination of abusive tax shelters required a significant amount of resources and time. The combination of (1) the growing backlog of tax shelter cases and (2) the amount of resources needed to handle the backlog led Congress to pass legislation to help IRS in detecting and deterring the promotion of abusive tax shelters.

Legislative Initiatives to Curb Abusive Tax Shelters

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) which, among other things, provided IRS its first compliance tools specifically aimed at curbing the promotion and sale of abusive tax shelters. In 1984, Congress further enhanced these tools in the Deficit Reduction Act (DRA) and authorized IRS to establish a tax shelter registration program. Moreover, the Tax Reform Act of 1986 (TRA) eliminated many of the provisions in the Tax Code that had been used in the promotion and sale of tax shelters.

Tax Equity and Fiscal Responsibility Act

The compliance tools provided by TEFRA consisted of several penalties that were incorporated into the Internal Revenue Code (IRC). The first, IRC section 6700, "Promoting Abusive Tax Shelters, Etc.," provided a civil penalty equal to the greater of $1,000 or 10 percent of the gross

income derived or to be derived from activities associated with the organization, promotion, and sale of any abusive tax shelter sold after September 4, 1982. The second, IRC section 6701, "Penalties for Aiding and Abetting Understatement of Tax Liability," authorized a civil penalty against anyone who knowingly aids and abets others in the understatement of their tax liabilities. The penalty is $1,000 per tax return for assistance to individuals and $10,000 per tax return for assistance to corporations. The penalty is imposed for each year in which the understatement occurs. The third, IRC section 7408, "Action To Enjoin Promoters of Abusive Tax Shelters, Etc.," permitted IRS to request the Department of Justice to petition federal district courts to prevent further sale or promotion of tax shelters IRS determined to meet the abusiveness criteria provided for in section 6700.

Deficit Reduction Act

The DRA increased the section 6700 promoter penalty from the greater of $1,000 or 10 percent to the greater of $1,000 or 20 percent of the gross income derived or to be derived from the promotion of an abusive tax shelter. The act also extended the authority to seek injunctive relief to include violations of section 6701. In addition, in section 6111, it required all tax shelters meeting certain established criteria to be registered with IRS. The purpose of registration was to provide IRS with information about the shelter when it is first offered for sale.

Tax Reform Act of 1986

Although TRA did not expand IRS' compliance tools for curbing the promotion and sales of abusive tax shelters, the act eliminated certain provisions that had been used to make abusive tax shelters attractive to investors. These provisions included certain investment tax credits, energy credits, and long-term capital gains. In addition, tax rates were lowered and accelerated depreciation write-offs were eliminated.

Another provision of TRA that could further deter the promotion of abusive shelters separated income into three classes (passive, active, and portfolio).[1] The act does not allow passive loss to be offset against income of the other two classes. Disallowing the offset of passive investment loss could reduce the promotion of some abusive tax shelters as they were previously structured. However, two provisions may lessen the deterrent effect of the passive loss offset provisions. First, the loss is

[1]Generally, passive income derives from any activity involving a trade or business in which the taxpayer does not materially participate. Active income results from receiving a salary or wage. Portfolio income is the result of dividends, interest, royalties, and gains on sale of investment property.

not considered passive if the investor "materially participates"[2] in the day-to-day operation of the partnership or business. Promoters, therefore, may attempt to circumvent the passive loss provision by restructuring tax shelters to create an appearance of material participation. Second, the act allows the offset of passive loss against other types of income when the shelter investment is liquidated. Thus, investors may attempt to circumvent the provisions by selling the shelter to another investor. In addition, promoters may continue making false or fraudulent statements in their offering material relative to tax benefits available to investors purchasing their shelter.

While the impact of TRA on future shelters is uncertain, history has shown that those who promote abusive tax shelters will develop new schemes to help investors avoid taxes.

IRS Initiatives to Detect and Deter Abusive Tax Shelters

In response to the various legislative initiatives, IRS initiated special programs and procedures to detect and deter abusive tax shelter promotions.

Before 1983, IRS' tax shelter program used an "after the fact" approach to identify, select, and examine tax returns containing tax shelter issues. That is, investors had already claimed the tax benefits and received related refunds before IRS examined their income tax returns. IRS had no means to stop investments in abusive tax shelters before the point of sale. As a result, the backlog of tax returns with tax shelter issues in IRS' examination inventory continued to grow.

To curtail the growth of tax returns with shelter issues, IRS in 1983 initiated an abusive tax shelter program to identify tax shelters using a "front-end" approach. The program's objectives are to (1) identify and penalize the promoters of abusive tax shelters before all investment units are marketed and (2) stop investors from claiming on their tax returns the tax credits and deductions generated by these shelters. To accomplish the program's objectives, IRS took the following steps.

- In 1983, IRS appointed an abusive tax shelter coordinator and formed abusive tax shelter committees in its district offices to review tax shelter cases for the purpose of determining whether to initiate penalty examinations of potentially abusive tax shelter promotions.

[2]Material participation generally requires one to have knowledge and experience about the trade or business and to participate in the day-to-day operations of the business.

- In 1984, IRS implemented the tax shelter registration program at the Kansas City Service Center, which is the registration point for all tax shelters required to register. The primary criterion for registering a shelter is that the ratio of (1) deductions plus 200 percent of the tax credits to (2) the amount invested must exceed 2 to 1 during any of the first 5 years. The program requires organizers, when a shelter is offered for sale, to file a registration form containing certain information on the characteristics of the shelter. This program provides IRS with its earliest opportunity to detect abusive shelters.
- In 1985, IRS established detection teams at all 10 service centers. They manually review tax returns and other tax documents to identify abusive shelters for penalty examination before the issuance of related investor income tax refunds.

Objectives, Scope, and Methodology

The Joint Committee on Taxation asked us to review IRS and Justice efforts to curtail the promotion and sale of abusive tax shelters. The Joint Committee asked that we place particular emphasis on the penalty and injunction provisions of TEFRA and DRA and the effectiveness of the tax shelter registration program. The promoter penalty and injunction provisions are only part of IRS' overall tax shelter program. We did not review the effectiveness of IRS efforts to deal with investors in abusive or nonabusive tax shelters.

The specific objectives of this assignment were to address the following questions:

- How effective are the registration and abusive shelter detection programs as front-end tools for identifying abusive tax shelter promotions?
- How effective are IRS' efforts to administer the abusive tax shelter penalty provisions provided by TEFRA and DRA relative to the assessment and collection of applicable penalties?
- How do IRS and Justice use injunctions against abusive tax shelter promoters to curtail further sale and promotion of abusive shelters?

To address the first objective relative to evaluating the success of the registration program in identifying abusive tax shelter promotions, we took a nationwide random sample of 500 registered tax shelter promotions that would allow us to project sample results to the universe of about 23,500 shelters that were registered between September 1984 and March 1986. Appendix II contains the details of our sampling and data analysis methodology. We analyzed the sample cases to determine whether tax shelters that registered did so when first offered for sale as

required by law. In addition, we traced 96 of our 500 sample cases that met the abusiveness penalty criteria and/or were filed late to determine the district's action on the case. We also discussed program efforts, accomplishments, and results with service center, district, regional, and national office officials.

To address the first objective relative to evaluating the success of the abusive tax shelter detection teams in identifying abusive tax shelter promotions, we did the following. First, we determined the number of tax documents and forms reviewed by the detection teams at three service centers during the period January 1985 through July 1986. Next, we determined that 599 cases were identified as potentially abusive and referred to district offices. We then reviewed IRS' records for all 599 cases referred to the 15 district offices serviced by these 3 service centers to determine whether the cases were either selected or rejected for abusiveness penalty examinations. Of the 599 cases, we reviewed IRS' records for 42 cases that were accepted for abusiveness penalty examinations by our three selected districts to determine if IRS found them abusive. We also discussed tax return review procedures, selection criteria, and referral package development with detection team, district, regional, and national office personnel.

To address the second objective dealing with IRS administration of tax shelter penalties, including collections, we used a mixed data collection approach. Using a data collection instrument, we reviewed all 93 abusive tax shelter penalty examination cases in three district offices. These cases had either been closed with penalties or the examinations discontinued because IRS found the shelter not sufficiently abusive to be subject to penalty. Our review included all examinations initiated from inception of the program on September 4, 1982, through July 31, 1986. In each case, we determined what TEFRA penalties, if any, were assessed, whether the evidence in the case file supported IRS' position, and whether the amount of penalty was correct. We also used structured interviews to obtain information on penalty assessment procedures followed and any problems experienced by district tax shelter penalty officials and revenue agents assigned to work the tax shelter penalty cases. To address IRS' collection of assessed penalties, we identified the promotions that were penalized and reviewed IRS' records to ascertain whether the penalty was billed and how much had been collected. In addition, we discussed specific case findings and collection procedures with the abusive tax shelter coordinators, district counsel officials, and revenue agents who did the examinations.

To address the third objective of assessing the use of injunctions, we determined the number of requests by IRS to Justice for injunctions, the number of injunctions granted by the courts, and the number of injunctions denied by either Justice or the courts and identified the reasons for the denials. We discussed the injunction process with IRS district, regional, and national office examination and counsel personnel, as well as with Justice officials.

In addition, we also analyzed the legislative history and penalty provisions of TEFRA and DRA and reviewed the IRC sections related to these provisions. We also reviewed the Internal Revenue Manual and IRS' policies and procedures pertaining to tax shelter identification, and penalty examination and assessment; and we obtained and analyzed IRS' statistics on tax shelter program efforts, penalties, injunctions, assessments, and collections for the period of September 1982 through July 1986. Appendixes III and IV summarize these statistics for the three selected districts.

We did our work at IRS' National Office; the Midwest, Southwest, and North Atlantic Regional Offices; the Chicago, Dallas, and Manhattan District Offices; and the Kansas City, Austin, and Brookhaven Service Centers. We selected these regions because IRS statistics showed that of the 370 penalty assessments at the time of our selection, approximately 50 percent of the assessments were in these three IRS regions. To complete our work, we then selected the largest district from each of these regions and the service center that services each of those three districts. Further, we reviewed and analyzed all tax shelter cases closed with penalties from the effective date of TEFRA on September 4, 1982, through July 31, 1986, in the selected districts. We discussed the scope of our work with national office tax shelter program officials. They agreed that the scope was sufficient to address overall IRS abusive tax shelter program operations.

We did our work from March 1986 through December 1986. Since that time, we did follow-up work to monitor program activities and to obtain information on any program changes. We did our work in accordance with generally accepted government auditing standards.

Changes Needed to Make Abusive Tax Shelter Identification Programs More Effective

To help keep the growing backlog of tax returns with shelter issues in IRS' examination inventory from increasing, Congress required the registration of certain shelters and provided IRS various penalties. IRS established a registration program, as well as a detection team program. One of the objectives of these programs was to identify and penalize abusive shelter promotions as early as possible, thereby reducing the number of related investor returns entering the income tax return examination process. By attaining this objective, IRS anticipated reducing the inventory of tax shelter examination cases. However, these programs have not identified a substantial number of shelters sufficiently abusive to be subject to penalty. Moreover, the number of returns in IRS' tax shelter examination inventory increased from about 285,000 to over 426,000 between the ends of fiscal years 1982 and 1986.

The registration and detection team programs have not been effective in identifying abusive shelters because (1) the registration program does not provide decisionmakers with enough detailed information on which to make a determination of whether to initiate a penalty examination and (2) the detection team program review selection criteria has not produced shelter cases that result in penalties. With better registration information, improved detection team review procedures and the establishment of national office selection criteria to be used by all IRS personnel, these programs should become more effective in identifying abusive tax shelters.

Registration Program Needs Information That Allows Decisionmakers to Make More Informed Decisions

To assist IRS' efforts to detect abusive tax shelter promoters, Congress authorized IRS to establish a tax shelter registration program. Under the program, shelter organizers are required, at the time a shelter is first offered for sale, to file a registration form with the Kansas City Service Center providing certain information on the shelter assets being sold, financing of investment units, and estimated tax benefits of the shelter. IRS district personnel ultimately review information on the forms and select for further examination shelters that show indications of asset overvaluation and/or false or fraudulent statements relative to allowable tax benefits to determine whether an abusiveness penalty can be assessed. The program, which provides IRS with its earliest opportunity to detect abusive shelters, has not met the program objective of identifying abusive shelters because the registration information is not sufficient for district personnel to make informed decisions on the potential abusiveness of a shelter.

From our review of 500 registered tax shelter promotions, projectable to a universe of about 23,500 registered shelters analyzed by Kansas City Service Center program personnel, we project that the Service Center sent the respective districts copies of the registration forms for 3,759 shelter promotions[1] because they met the program criteria for potential abusiveness. Table 2.1 shows the status of the 3,759 tax shelters.

Table 2.1: Projected Nationwide Status as of September 1986 on Shelters the Registration Program Identified as Potentially Abusive

District action	Projected number of tax shelters	Percent of total
Penalty examination was not initiated, shelter prospectus and offering documents not obtained	2,443	65
Penalty examination was completed, districts found shelter not subject to penalty	799	21
Penalty examination in progress	423	11
Transferred to other districts—status unknown	94	3
Total	**3,759**	**100**

As shown in table 2.1, our review disclosed that using the information on the registration form, we estimate that IRS decided not to initiate a penalty examination in 65 percent or 2,443 of the 3,759 projected shelter promotion cases. Likewise, using the registration information, IRS initiated penalty examinations on approximately 799 shelters that were found not to be subject to a penalty.

To further assess the usefulness of the registration program in identifying abusive tax shelters, we reviewed the statistics and outcome of examinations that were initiated based on registration information. With respect to the three districts we visited, registration program information was used by district program personnel to initiate 24 abusive shelter penalty examinations from October 1984 through July 1986. Of the 24 examinations initiated, IRS had completed 20 as of July 1986 and concluded that the shelters were not sufficiently abusive to be subject to a penalty.

In discussing the fact that no shelters subject to penalty were detected through the registration program as of July 1986, shelter program personnel in the three districts told us that information provided on the registration form is not sufficient for making an informed decision on

[1]The 3,759 registration forms were referred from October 1984 to November 1985. At that time, the Kansas City Service Center stopped analyzing and sending the districts only those registration forms which met program criteria for potential abusiveness. It now sends more timely copies of all forms to the districts, which analyzes them based on program criteria for examination potential.

whether to initiate a penalty examination. These personnel contended that the shelter's prospectus and offering documents would fill the information void that presently exists and that data from these documents would be helpful in deciding whether a shelter penalty examination is warranted. However, IRS usually obtains those documents after deciding to examine the shelter and does not require the documents to be submitted when the shelter is registered. An IRS task force, which was established in October 1986 after our review to assess the registration program, also concluded that information on the registration forms is not sufficient to attain the program's objective of identifying abusive tax shelters as early as possible.

The prospectus and offering documents provide details of information shown in summary format on the registration form. For example, the tax benefits on the registration form are expressed in terms of a write-off ratio of deductions and credits to cash investment without considering any shelter income. In contrast, the prospectus and offering material would describe, in detail, information about income projections as well as the amount and type of deductions and credits an investor could expect. Such information can be used in evaluating the economic reality of the shelter and to what extent the investment would be tax motivated. In addition, the information concerning the asset acquisition and financing could indicate that the shelter asset may be overvalued. Therefore, these shelter documents would provide IRS a means of verifying the accuracy of all registration data and also would provide IRS with information to make more informed decisions on whether the shelter showed indications of meeting section 6700 penalty criteria. These criteria are (1) the overvaluation of an asset by more than 200 percent, that is, the claimed value is more than double the market or appraised value or (2) false or fraudulent statements about tax benefits.

If IRS had more information, such as the shelter prospectus and offering documents, it may have been able to select for examination shelters subject to penalty. Likewise, if IRS had such information, it may not have initiated examinations on some shelters which were found not to be subject to penalty during examination.

Better Selection Criteria and Expanded Computer Use Can Improve the Detection Team Program

IRS established a detection team program in each of its 10 service centers in an effort to identify abusive shelters as quickly as possible to prevent individuals from claiming tax benefits derived from these shelters on their tax returns. IRS anticipated that this program would prevent the backlog of tax shelter cases in examination from growing and eliminate a potential collection problem. Although the concept of the detection team program has merit, it has not been successful in identifying more potentially abusive shelters because (1) the criteria used to identify abusive tax shelters differ between the service center detection teams and IRS district examination personnel and (2) IRS is not efficiently or effectively using computers to select tax returns for detection team review. As a result, the districts are rejecting the majority of detection team shelter referrals for penalty examinations, and the detection team review process, which is primarily performed manually as compared to by computers, is more labor intensive than necessary. By developing standard selection criteria, detection teams should become more effective. And, by expanding the use of computers to identify potentially abusive shelter returns and documents, the teams could become more efficient.

IRS Needs to Establish Selection Criteria That Can More Accurately Identify Abusive Shelters

Effective identification of abusive tax shelters depends on the use of specific consistent selection criteria by both service center detection teams and district office personnel to make decisions on the potential abusiveness of tax shelters. However, detection team personnel and district personnel do not use the same criteria when they review tax returns and other tax documents for abusiveness issues. Using detection team guidelines, team personnel look at the losses and tax credits claimed on tax returns. District personnel, on the other hand, look for the overvaluation of an asset by over 200 percent and/or false or fraudulent statements, both of which are section 6700 penalty criteria. As a result, district personnel reject the majority of shelters identified by the detection teams for penalty examinations. Detection teams and district personnel use different criteria because IRS headquarters has not developed specific criteria for nationwide application.

From January 1985 through July 1986, detection teams at the 3 service centers we visited developed and referred to the 15 districts they service, 599 cases that met the teams' selection criteria for potential penalty examinations. However, program personnel in these districts rejected 66 percent, or 397, of the 599 cases for penalty examinations because they did not find evidence of abusiveness when they applied section 6700 criteria. Of the remaining 202 cases, district personnel

accepted 123 cases for penalty examination, accepted 22 cases for criminal investigation, and rejected 57 cases for various reasons, such as an examination already being in progress or the case file being incomplete.

To further assess the effectiveness of the detection team program, we reviewed the status of all 42 detection team cases accepted for section 6700 penalty examinations between January 1985 through July 1986 by the three districts we visited. As of July 31, 1986, examinations had been completed on 9 of the 42 accepted cases, resulting in one section 6700 penalty for $148,000.

In discussing the fact that the detection team program had identified one abusive shelter in the 3 districts and that 66 percent of the cases referred to 15 districts were rejected, IRS national office officials told us that even though many cases did not result in section 6700 penalty assessments, some cases the program identified would result in income tax assessments. We reviewed IRS records on 172 of the 397 cases rejected by the 15 districts to determine whether the examination of these shelters resulted in income tax adjustments.[2] As of September 1986, IRS records showed the following for the 172 cases reviewed.

- Twenty cases (12 percent) had income tax examinations completed, and district personnel concluded that in each case no additional income tax was due.
- Forty-three cases (25 percent) were no longer being considered for an income tax examination.
- Twenty-seven cases (16 percent) had no indication whether an income tax examination was considered.
- Eighty-two cases (47 percent) had an indication that either an income tax examination was still being considered or the examination was in progress.

Through our analysis, therefore, we were unable to identify any income tax assessments being made for returns selected by the detection teams.

Unless IRS develops criteria for what constitutes an abusive shelter, which both detection team and district personnel can apply, the effectiveness of the detection team program will remain questionable. An IRS task force study on the detection team program, initiated in September

[2]The 172 selected cases represent all of the cases referred to the 15 districts in 1985 that were determined by district personnel to have income tax examination potential but no penalty examination potential. We limited our test to 1985 cases to allow time for the examinations to be completed.

1986, also concluded that IRS needs to develop new selection criteria. According to the task force report, IRS national office program personnel are developing an abusive tax shelter profile, which is based on historical data of known abusive shelters and will be used by IRS to develop national selection criteria.

We believe developing criteria is a positive action that could improve the effectiveness of the detection team program. Given the changes in TRA, however, IRS will also need to update the profile periodically to be of most benefit for early detection.

IRS Needs to Make More Extensive Use of Computers to Screen and Identify Abusive Shelter Returns for Detection Team Review

Service centers receive millions of tax returns and other tax documents annually that might pertain to an abusive tax shelter. Prior to the detection team review process, some computer screening of tax returns occurs to reduce the number of tax returns and other documents that detection teams must manually review in order to identify cases to be referred to the districts. By using the computer, IRS eliminated the need to manually review millions of individual income tax returns. However, IRS does not computer screen millions of other tax returns and documents. Instead, detection teams are required to manually review all partnership returns, small corporation returns, and certain types of other tax documents along with those individual returns selected by the computer in an attempt to identify potentially abusive tax shelter cases.

Even with computer screening, IRS personnel costs to make the manual reviews is significant, particularly given the low number of abusive shelters detected through the program. On the basis of staff day and cost data provided by IRS, we calculated that detection team personnel costs at the three service centers visited, amounted to about $1.7 million from January 1, 1985, through July 31, 1986. During this time, detection team personnel at the three service centers manually reviewed 3.3 million documents. These included 400,000 individual income tax returns that the computer selected for further screening.

If IRS expanded the use of computers in the identification process to include other types of tax returns, we believe that a greater number of tax shelters having abusive shelter penalty examination potential should ultimately be referred to the districts at less cost. Of course, efficient identification of abusive tax shelters is dependent on IRS' ability to develop criteria that can be computerized. As previously discussed, the detection team process has not identified an appreciable number of shelters subject to penalty. This would indicate that existing computerized

criteria needs some modification. As IRS develops its profile of abusive tax shelters in order to establish national selection criteria, it also needs to computerize the criteria to the maximum extent possible to reduce the number of returns needing manual screening and related personnel costs.

Conclusions

In an effort to reduce the growing backlog of tax returns with shelter issues in its examination inventory, IRS implemented the tax shelter registration program and the detection team program. However, the registration and detection team programs have not identified an appreciable number of tax shelters subject to penalty.

The registration program provides IRS with its earliest opportunity to detect abusive shelters because it provides certain information about the shelter when it is first offered for sale. However, we, as well as IRS' task force, recognize that the registration form alone does not provide IRS with the type of information needed to make informed decisions on the penalty potential of the shelter. As a result, shelters potentially subject to penalty may be going undetected through the registration program.

The detection team program is IRS' next attempt to identify abusive tax shelters early. However, this effort has detected only one shelter subject to penalty in the three selected districts we visited. This could be due to IRS not developing selection criteria for the teams that identify the type of shelter cases district decisionmakers consider potentially subject to penalty. Additionally, the detection team review process is not as efficient as it could be because IRS has not used computers to the maximum extent possible to identify, and thus limit, the number of returns detection teams must review.

Recommendations

To improve the efficiency and effectiveness of the abusive shelter identification programs, we recommend that the Commissioner of Internal Revenue take the following actions.

- Require organizers of registered shelters to provide the shelter prospectus and offering documents to their respective IRS district offices at the time of registration.
- Require districts to review these documents in deciding whether to initiate an examination to determine if the shelter is subject to penalty.

- Develop and periodically update national selection criteria that can be used by IRS service center detection teams and district examination personnel to identify the tax shelter returns most likely to contain a gross overvaluation of an asset or false or fraudulent statement.
- Maximize the use of computers to identify and thus reduce cases for detection team review.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS expressed the belief that although the full impact of the Tax Reform Act of 1986 on tax shelters will not be known for a few years, the act will dramatically curtail the use of abusive tax shelters. It believes, therefore, that implementation of many of our recommended changes to IRS' abusive shelter identification and enforcement programs should be delayed pending analysis of the full impact of the act on tax shelters. Thus, IRS' position is to generally maintain the status quo in terms of its present programs.

We agree that TRA eliminated certain provisions that had been used to create and promote abusive tax shelters. We also agree that it is not certain, and will not be for some time, what the total impact of the act on abusive shelters will be. On the other hand, we recognize that promoters may be able to circumvent some of the act's provisions by restructuring tax shelters. Also, even though the act disallows the offsetting of passive losses against active or portfolio income while an investment is being carried, investors may attempt to circumvent the provision by selling the shelters to another investor.

Evidence shows that while TRA apparently reduced the number of shelters registering with IRS, a substantial number of shelters have continued to register since the act went into effect. In 1987, IRS registered 5,293 shelters or about 57 percent of the number of shelters registered in the year prior to the act. While we are not suggesting that all of these shelters are abusive, the creation of tax shelters is still plentiful and history has shown that people always find new ways to abuse the tax system.

Therefore, we disagree with IRS' decision to continue its programs to identify and examine abusive tax shelters but delay improving those programs. Our recommendations are intended to make the programs more efficient and effective. They are not intended to be cost or labor intensive or difficult to implement. Thus, since IRS is continuing its programs, it should not delay implementing our recommendations. Moreover, by making improvements to its abusive shelter efforts now, IRS

should be able to more readily identify the nature of emerging post-TRA shelters and determine the impact of TRA on the promotion of abusive shelters.

Regarding the specific recommendations in this chapter, IRS disagreed with our recommendations to improve the registration program. It agreed in principle with our recommendations to improve the detection team program, but raised several issues regarding the recommendations and the evidence upon which they are based.

Registration Program

IRS raised several objections to our recommendations for obtaining shelter prospectuses and offering documents as a part of the registration process and requiring district personnel to review them in deciding whether to initiate shelter penalty examinations. First, IRS does not believe it has the authority to require the submission of prospectuses and/or offering documents as part of the registration process. Second, it believes requiring all entities subject to registration to prepare prospectuses and offering documents would impose unwarranted burdens on legitimate businesses. Third, it believes that if submission of prospectuses is required and IRS does not examine the related shelters, IRS' approval of the promotions may be implied.

With regard to IRS' first objection, we believe that the Secretary of the Treasury clearly has the authority to require the submission of prospectuses and/or offering documents as part of the registration process. The language of section 6111 of the Internal Revenue Code, as added by section 141a of the Deficit Reduction Act of 1984, provides that a tax shelter organization shall register with the Secretary of the Treasury in such form and in such manner as the Secretary prescribes. Subsection (a)(2) of section 6111 describes the information that must be provided to IRS when a tax shelter is registered, including information identifying and describing the shelter, the tax benefits of the shelter, and "such other information as the Secretary may prescribe." (Underscoring provided.) Furthermore, the Secretary clearly has authority under section 6707 of the Internal Revenue Code to impose a penalty on any organizer who does not provide all registration information required by the Secretary.

IRS questions whether it has the authority to require the submission of prospectuses and/or offering materials on the basis that the committee report for the Deficit Reduction Act of 1984 describes registration as disclosure on a simple form and supplying information that briefly describes the investment. While we acknowledge the language of the

committee report, we do not agree that a tax shelter registrant's submission of a shelter prospectus and offering documents with the registration form makes the form any more complex or lengthy. Our recommendation would not require the inclusion of more information on the registration form. Rather, it would require shelter organizers to provide information to IRS, which they seemingly would already have available. Moreover, there is nothing in the committee report to suggest that the conferees intended to elevate "briefness" over the legitimate information needs of the Secretary of the Treasury.

With regard to IRS' second objection, IRS said that our recommendation would place an unwarranted legal and paperwork burden on legitimate businesses because shelter organizers might have to prepare offering documents that do not exist. However, in further commenting on our recommendation, IRS said that "presently prospectuses are requested and reviewed by districts where registration applications contain indications of potential abuse." In our opinion, this would indicate that currently once IRS decides that shelters are potentially abusive, the offering documents are made available if they exist or the shelter organizers have to prepare them for IRS. Neither we nor IRS know precisely the extent to which shelters that register would not have offering documents for potential investors to review before they invest in the shelters. However, it is difficult for us to envision many individuals investing in a shelter subject to registration strictly on the basis of verbal statements made by the shelter organizer, promoter, or salesperson. Moreover, if providing the prospectus or offering documents would create an undue burden on a legitimate shelter, the Secretary has authority under section 6111(e) to exempt the shelter from the registration requirements.

With regard to IRS' third objection, IRS argued that if the submission of offering documents were required and the shelter was not examined, investors might construe that IRS considers the shelter to be legitimate. This argument could be raised concerning any tax return that IRS receives but does not examine. In fact, district program officials said that some promoters were already using IRS' issuance of a tax shelter registration number as a sales gimmick to encourage investors to buy the "IRS approved" shelter. Therefore, we do not believe this is a valid reason for not requiring prospectuses and/or other offering documents that could help IRS better identify abusive shelters for penalty examination.

In sum, we believe that the registration program has potential to be an effective up-front mechanism for identifying abusive tax shelters for examination. However, the program has less chance of achieving its potential if IRS does not have access to more detailed information, such as that contained in a shelter prospectus, when it is deciding whether a shelter should be examined for potential abuse and a penalty assessment. Therefore, we believe IRS should reconsider implementing our recommendations.

Service Center Detection Teams

IRS agreed in principle with our recommendations to (1) develop criteria that service center detection teams and district examination personnel can use to select potentially abusive tax shelters subject to penalty and (2) computerize the criteria to the maximum extent possible. However, IRS did not explicitly agree to implement the recommendations. Rather, IRS indicated that our recommendation regarding the selection criteria is not practical because of the differences in the qualifications of detection team and district personnel and the information available to them. IRS also said we based our recommendations on the inaccurate premises that (1) IRS had not previously attempted to develop better criteria and maximize the use of computers to reduce the number of returns reviewed by detection teams and (2) the service center detection teams had not been successful.

Both we and IRS agree that the purpose of the detection team is to identify indications of abusive shelters for possible further development by district offices. What we seem to disagree on is the relative measures of success to expect from the detection team efforts. Our point is that very few abusive shelter penalty examinations resulted from detection team referrals in the districts we reviewed and our objective is to reduce the number of cases forwarded by the detection teams that are subsequently screened out by the districts.

In this regard, we found that one reason for the large number of rejected cases was the different criteria being used by the teams and the districts. The thrust of our recommendation was toward reducing that difference. IRS responded that these differences must remain because of other differences in personnel qualifications and available information. We recognize that expertise and information may vary between service centers and districts and that it may not be practical for the detection team to apply the unwritten, judgmental criteria presently being applied at the district. Neither would we want their dual efforts to be duplicative. However, we also recognize that without some change the purpose

of the detection team is being defeated by the large number of referral cases rejected by the district. Thus, the intent of our recommendation is that detection team, district office, and national office personnel work together to develop detection team criteria that will result in increasing the number of referred cases accepted by the district for further investigation. We continue to support this intent.

IRS also pointed out that we did not consider the need for geographical flexibility in recommending consistent criteria. IRS argues that such flexibility is important because IRS considers the number of potential shelter investors of equal or greater importance than monetary loss to the government. This is because a large number of investors can have a more deleterious effect on voluntary compliance. We are unsure what in our recommendation concerns IRS. Our recommendation does not preclude geographic flexibility in selecting and examining shelters.

Regarding our recommendation that IRS maximize the use of computers to identify cases for detection team review, IRS said it has annually modified the computer criteria used to select and reduce the number of returns for manual review by detection teams. IRS also said some returns cannot be computer screened because of service center tax return processing priorities. Because of the way IRS designed the detection team program, millions of returns are manually reviewed without prior computer screening. IRS opted for this approach to identify potentially abusive shelters in a more timely manner and to stop shelter investors from getting claimed refunds—a major benefit according to IRS.

We agree that IRS had made some modifications to computer selection criteria that reduced the number of returns detection teams reviewed. Our point is that computer selection should be extended to return types that are presently being screened manually to improve program efficiency. As discussed above, IRS is manually screening returns to stop shelter investors from getting claimed refunds. We recognize the desirability of not making a refund over making a refund and having to take it back. However, as with most situations this one involves tradeoffs. According to IRS' detection team task force report, IRS can readily collect up to 93 percent of shelter tax deficiencies. Therefore, IRS statistics do not indicate that holding investor refunds would cause any substantial collection problem. On the other hand, IRS forgoes any revenue that would accrue from penalties and penalty interest on the tax deficiency because IRS held the refund. Therefore, we believe that IRS should reconsider the cost and benefits of computer screening additional returns that presently are manually screened.

Lastly, IRS questioned our conclusion that detection teams were not successful in identifying shelters that were abusive because, in IRS' opinion, the scope of our review was insufficient. IRS said its detection team task force findings are a better indication of the success achieved by detection teams. While the task force report and our report differ in certain respects, the task force report also concluded that the selection criteria used by detection teams should be revised.

Legislative and Administrative Changes Are Needed to Improve Tax Shelter Penalty Assessments

Congress included in TEFRA and DRA a total of four penalty provisions intended to deter the promotion and sale of abusive tax shelters. However, irrespective of these penalties, financial incentives remain that could encourage further promotions. Promoters can retain as much as 80 percent of the shelter gross income after paying the penalty for promoting an abusive shelter because the law limits the penalty for promoting such shelters to the greater of $1,000 or 20 percent of gross income derived from the shelters. In the three districts we visited, this resulted in promotions retaining millions of dollars even after penalties. Also, according to IRS officials, penalties were not assessed against persons connected with abusive shelter promotions who may have aided and abetted others in understating their tax liability because the law states that a person must knowingly aid and abet, and that is difficult to prove. As a result, about $3 million in potential penalties for aiding and abetting were not assessed in the three districts we visited. Changing the legislative language to "knows or reasonably should have known" should facilitate IRS' assessment of the penalty. Aside from these legislative issues, IRS could have better administered the various shelter penalties. In the three districts we visited, IRS made computation or oversight errors, which collectively resulted in about $4.2 million in underassessed penalties.

Congress also included in DRA a penalty for registration program late filing. Because of the way districts were administering the penalty, IRS lost millions of dollars nationwide during the first 18 months the registration program was in operation. However, since we notified IRS of this problem, it is in the process of trying to develop a more efficient and effective way of administering the registration program late filing penalty.

We also found that, while IRS had successfully obtained injunctions against abusive tax shelter promoters on a number of occasions, IRS does not have a system to monitor compliance with injunction decrees even though violations have occurred.

Changes to Section 6700 Needed to Remove Financial Incentive for Promoting Abusive Tax Shelters

The penalty for promoting abusive tax shelters under section 6700 is the greater of $1,000 or 20 percent of gross income derived or to be derived by such persons for such activity. The penalty may not serve as a financial disincentive because the promoter can retain up to 80 percent of gross income.

The percentage penalty rate established by TEFRA amounted to 10 percent of gross income derived. DRA raised the rate to 20 percent of gross income because it was brought to the Congress' attention that promoters operated on a large gross income margin. However, the 20 percent of gross income penalty also allows promoters to retain substantial amounts of money.

In 28 penalty cases closed as of July 31, 1986, at the three districts we visited, IRS personnel had assessed a section 6700 penalty against promoters in 18 of those cases.[1] In all 18 cases, the promoter was able to retain a portion of gross income derived from the sale of the abusive shelter. In 9 of the 18 cases for which gross income data was available in the case file, the promoters collectively retained about $54 million of gross income after penalties. The amounts retained ranged from about $0.5 million to $18 million in gross income. The gross income percentages ranged from 78 percent to 95 percent.

We could not determine how much net income the promoters made. The case files we reviewed did not contain such information because it is not needed by IRS in arriving at the amount of the penalty. Moreover, IRS has no overall statistics on gross or net income earned by promoters on the sale of tax shelters.

The section 6700 penalty is IRS' primary tool for deterring the promotion of abusive tax shelters. However, if the penalty is to curb promotions as intended by Congress, the current penalty rate of 20 percent of gross income does not seem sufficient to remove the financial incentive. To enhance the impact of the penalty, Congress would need to significantly increase the penalty rate above 20 percent of the gross income derived by all parties involved in the promotion and sale of abusive tax shelters. The higher the percentage, of course, the greater the deterrent should be. Increasing the penalty rate to any percent short of 100 would reduce

[1]In the 10 other cases, the section 6700 penalty was assessed against salespersons or practitioners fo activities related to promotions found abusive in districts other than where we conducted our review or pertained to shelter penalties other than section 6700.

the promoter's gross income but might still allow promoters to continue making a profit depending on the rate established.

Section 6701 Could Be Improved as a Financial Disincentive for Aiding and Abetting

IRC section 6701 authorizes IRS to assess a penalty against anyone who knowingly aids or abets others in understating their tax liabilities. Because of the specific reference in section 6701 to knowingly aiding and abetting, IRS applies two standards of proof: first, the information or advice was provided in connection with a material matter; second, the person providing the information or advice knew it would result in an understatement of another person's tax liability. In applying the standards, IRS takes the position that the section 6701 penalty can only be assessed when some person connected with the shelter either signs the promoter's or investor's tax return, prepares the (Schedule K-1) Partner's Share of Income, Credits, Deductions, etc., or signs other documents that cite tax benefits.

IRS' counsel and district office officials established these criteria because of the anticipated difficulty of proving in court that someone "knowingly" aided and abetted in the understatement of another person's tax liability absent a signed document that can be tied directly to the investor's income tax return. The difficulty in proving that someone "knowingly" aided and abetted has minimized the financial disincentive of the penalty because IRS officials are reluctant to assess the penalty if the case is likely to be lost in court. For example, of the 18 tax shelter promoter cases IRS found abusive in the three district offices, the section 6701 penalty was assessed in 5 of the abusive shelters cases. In all 18 cases, IRS found that the promoter overvalued the shelter asset by more than 200 percent or had made false or fraudulent statements relative to the purported tax benefits. In addition, IRS found that about 3,000 persons had invested in the 13 shelters for which no section 6701 penalty was assessed. If IRS could have assessed section 6701 penalties in these 13 cases for 1 tax year, the assessed penalties would have amounted to about $3 million.

IRS counsel officials and district office shelter examination officials said that no section 6701 penalty was proposed in these 13 cases because of the difficulty of proving—absent any signed documents used by investors to file their income tax returns—that some person "knowingly" aided and abetted the investor. IRS counsel and district examination officials agree that some persons associated with the shelter, in many cases the practitioners (accountants, attorneys, tax consultants, appraisers, etc.) provided information or advice that helped investors claim the

overstated deductions and credits on their tax returns. IRS counsel officials' position is that these practitioners are well aware how their opinions, appraisals, or other information will be used relative to abusive tax shelter promotions. Further, IRS counsel officials said many investors rely upon the opinions of these practitioners as the basis for investing in tax shelters. However, proving in court that those practitioners who provided information or advice about the shelter "knowingly" aided and abetted the taxpayer to take undeserved deductions and tax credits is difficult, if not impossible, to prove absent signed documents used by investors in filing their tax returns.

To the extent that IRS is unable to assess a section 6701 penalty, its effect as a financial disincentive could be minimized. IRS counsel and examination officials agree with us that if the statute could be changed to lower the level of proof from knowingly to "knows or reasonably should have known," IRS would have more opportunity to assert the penalty and enhance its effectiveness as a financial disincentive.

Better Guidance and Procedures Would Make Penalty Assessments More Accurate

Abusive tax shelter penalties amounting to about $4.2 million had been either overlooked, or miscomputed by the three IRS district offices from September 1982 through July 1986. Thirty errors were made in 14 of the 28 shelters cases closed with penalties. In 5 of the 14 cases, both types of errors were made. Further, 10 additional errors were made in 1 of the 28 cases and in 1 other open case where penalties had been proposed but not assessed. The errors and oversights occurred because (1) IRS' national office provided incomplete guidance to districts, and, as a result, the districts were not always aware when certain penalties applied; and (2) IRS' districts have no internal control procedures for reviewing penalty cases to ascertain whether all appropriate penalties were considered and accurately assessed.

Incomplete Guidelines Caused Section 6700 Penalties to Be Overlooked

IRS' district offices assess abusive tax shelter penalties based on the district's interpretation of guidance from IRS' national office. IRS' national office guidelines for section 6700 penalty assessments direct the districts to penalize anyone who organizes, sells, or promotes an abusive tax shelter. The guidelines require the penalty be the greater of $1,000 per activity or 20 percent of the gross income derived or to be derived from such activity. The guidelines illustrate penalty computation by multiplying $1,000 times the number of sales made.

The guidelines do not show how to compute the penalty when multiple acts of organizing, promoting, and selling were committed by the same person. As a result, shelter program officials in only one of the three districts reviewed were aware that more than one act committed by the same person was subject to penalty. Shelter program officials in the other two districts did not know multiple acts were subject to penalty. Moreover, they were not aware that organizing in itself was an act subject to penalty. Had the guidelines addressed multiple acts in illustrated examples, these problems could have been avoided.

Due to the incomplete guidance provided by IRS' national office, $166,000 in penalties were overlooked in 11 of 28 closed cases at the three districts visited. In two of the three districts visited, IRS overlooked $130,000 in section 6700 penalties for multiple acts committed in seven closed cases. Even though one district was aware that multiple acts were subject to penalty and had assessed penalties against some shelters, it also overlooked these penalties against four closed shelter cases and understated penalties by about $36,000. To prevent future penalties from being overlooked, IRS needs to revise its guidance to demonstrate how to compute the section 6700 penalty when multiple acts are involved.

Better Internal Control Procedures Could Reduce Penalty Computation and Oversight Errors

The Internal Revenue Manual does not require districts to establish internal control procedures for the review of shelter penalty computations or assessments. Absent this requirement, none of the three districts reviewed had procedures to ensure all abusive shelter penalties were considered, computed accurately, and assessed. As a result, we found 10 computation or oversight errors in 8 of the 28 shelter cases closed in the three districts visited, amounting to about $1.5 million in underassessed penalties. Another 10 oversight errors amounting to $2.5 million were made in 2 cases where the penalty had been proposed but not assessed.

Reasons for the computation errors varied from district to district and computation to computation. In addition, we found IRS national office officials did not routinely review penalty case files to ascertain whether district offices were assessing penalties in accordance with national office guidelines or were being assessed consistently between districts. These errors resulted from erroneous mathematical computations, applicable penalties overlooked by district personnel, and misapplication of policies and procedures. Nevertheless, none of the districts had internal control procedures in place to detect these errors and oversights.

IRS officials in all three district offices agreed with us that $4.2 million in penalties were computed incorrectly or overlooked. However, these officials said that none of the $166,000 in multiple act penalties that were overlooked or the $1.5 million in computation or oversight errors could be corrected because the penalties had already been assessed and the cases closed. At our suggestion, IRS did assess the $2.5 million in penalties that were overlooked in the two cases where penalties had been proposed but not assessed.

Internal control procedures to assure that all abusive shelter penalties are considered and accurately computed prior to assessment could reduce the numbers of these kinds of errors and oversights. At a minimum, these procedures should include supervisory review of all cases and district quality review of selected cases as currently is performed on other types of examination cases.

IRS Plans Improvements for Administering the Registration Penalty

DRA gave IRS the authority to establish a tax shelter registration program. It added code section 6707 that allows IRS to, among other things, penalize anyone who registers after the prescribed time period. We found that the program IRS had implemented to administer this penalty was neither efficient nor effective. National office officials agreed that improvements were needed in the administration of the penalty.

Tax shelters that meet certain established criteria are required to be registered with IRS on or before the date the shelter is first offered for sale. The penalty for violating this requirement is the greater of $500 or 1 percent of the aggregate amount invested in the shelter promotion. IRS' national office established a grace period[2] for late filing and delegated administration of the registration penalty to its district offices.

District offices are supposed to review the registration application to identify registration forms filed late and propose a late filing penalty, if appropriate. Two of the three districts visited established a late filing grace period longer than the grace period established by the national office. One of the two districts was not aware of the national office's grace period. As of July 31, 1986, the two districts, using the extended grace period, assessed 33 late filing penalties totaling about $220,000. In contrast, the third district had not assessed any late filing penalties. It

[2]The grace period is restricted data and cannot be disclosed.

was the position of this district, as well as that of one of the other districts we reviewed, that the program was too new to routinely assess late filing penalties.

We reviewed a random sample of 500 registration forms filed nationwide during the first 18 months of the program and found that 42 percent of the registration forms were filed later than the national office prescribed grace period. We projected that IRS could have proposed penalties of about $49 million, nationwide, using the prescribed grace period but for the most part had not assessed a significant amount of penalties.

IRS did not begin maintaining statistics on late filing penalties until January 1986. For the ensuing 15 months, IRS, nationwide, assessed late filing penalties amounting to about $786,000 in 151 cases. We projected for the 8 months from July 1985 to March 1986 that penalties of $18.3 million could have been proposed.

During our review, we briefed national office officials on our findings regarding how the districts were administering the section 6707 late filing penalty. Until that point, national office officials were not aware of how the districts were administering the penalty and had not considered centralized administration of the penalty. We suggested that a more efficient and effective program could be attained if it were administered out of the Kansas City Service Center, which receives all registration forms. We also proposed that IRS develop a program to use existing computer resources to generate notices of proposed late filing penalties.

In December 1986, IRS officials said they would consider our suggestions as a part of a task force review of the registration program. As of February 1988, the Kansas City Service Center was in the process of testing 100 cases to determine the best system for proposing and assessing the penalty.

Injunctions Have Been Obtained Against Abusive Tax Shelters But No Procedures to Ensure Compliance Exist

Injunctions can serve as an effective deterrent against the sale of abusive tax shelters. The promoter not only is enjoined from promoting and selling the presently marketed abusive tax shelter but also enjoined from promoting and selling other abusive tax shelters for a specified number of years. Although the enjoined parties are supposed to report their shelter activities to IRS during the specified time period, IRS has no system to monitor these activities to determine whether the enjoined parties are complying with the injunctions.

IRS is authorized to seek injunctions from the courts against anyone who promotes, organizes, or sells an abusive tax shelter and against anyone who aids and abets in the understatement of tax liability. From September 1982, when TEFRA became effective, through April 1986, IRS had sought injunctive relief against 167 abusive promotions nationwide. Of the 167 referrals to Justice, injunction decrees were either granted by the courts or entered into by consent of the parties in 78 cases. Of the remaining 89 cases referred to Justice, 39 were awaiting court review, 10 were pending at Justice, the status of 3 cases could not be determined, and 37 were returned to IRS. These 37 cases were returned to IRS primarily because Justice requires IRS to show that sales activity occurred in the past 12 months before pursuing the injunction request, but IRS had no evidence that the shelters had been sold in the past 12 months. It was, therefore, Justice's position that injunctions were not warranted.

Injunctive relief can take the form of either a consent decree or court order and generally provides that the party enjoined must refrain from selling abusive tax shelters for a specified period of time and must advise IRS concerning any future tax shelter sales. However, IRS has no system to monitor compliance with either consent or court-ordered injunctions. Therefore, IRS, in most cases, does not know whether those enjoined subsequently violated the injunction by promoting and/or selling the enjoined shelter or any other abusive shelter. IRS officials told us of two cases where persons violated the terms of their injunctions and were sentenced to prison. However, IRS learned about these violations by means other than through an established monitoring system, such as while investigating another shelter.

If IRS implements our recommendation in chapter 2 to develop a computerized return selection system to be used by service center detection teams in identifying abusive tax shelter promoters, this system could also be used to monitor future compliance with injunction decrees. This

could be done by identifying and reviewing tax data filed by enjoined parties.

Conclusions

Although TRA eliminated many of the tax provisions that led to the proliferation of abusive tax shelters in the 1970s and early 1980s, history has shown that new types of abusive tax shelters are developed to avoid tax liabilities. Consequently, Congress and IRS must continue to seek ways to remove the financial incentive for promoting abusive tax shelters. In addition, IRS must effectively use the tools provided to curb the sale of abusive tax shelters.

To make the promotion and sale of abusive tax shelters financially unattractive, legislative changes are needed to section 6700 and section 6701. Under section 6700, promoters can retain as much as 80 percent of gross income derived from the sale of abusive shelters. This penalty would provide a greater financial disincentive if it were higher. IRS did not assess the section 6701 penalty against persons connected with most abusive shelters because language in the code section makes the aiding and abetting penalty difficult to prove. IRS officials agree with us that if the language in section 6701 was changed from knowingly to "knows or reasonably should have known," the penalty could be assessed more often and serve as a greater financial disincentive.

Because of incomplete guidance and oversight by IRS' national and district office officials and the absence of internal controls for penalty verification at the three districts visited, shelter penalties were overlooked or miscomputed. Incomplete guidance caused about $166,000 in penalties to be overlooked when multiple acts were committed by the same person. Another $1.5 million in penalties have been lost because IRS examination personnel either overlooked or erroneously computed the amount of the penalty.

Lastly, in some cases, IRS had obtained injunctions that require the enjoined parties not to promote or sell abusive tax shelters for a specified period of time. However, IRS has not established a program to ensure compliance with the terms of the injunctions. A computer monitoring system could be an effective way to monitor compliance.

Recommendations

To reduce the financial incentive for promoting abusive tax shelters, we recommend that Congress enact the following legislation:

- Modify IRC section 6700 to significantly increase the penalty above the current 20 percent of gross income derived, or to be derived, by any party involved with the promotion or sale of an abusive shelter.
- Modify IRC Section 6701 to reduce the level of proof from knowingly to "knows or reasonably should have known" that the investor would understate tax liability to ensure all abusive shelters are subject to penalty for aiding and abetting.

To ensure that penalties are assessed when appropriate and computed correctly, and that enjoined parties comply with the terms of the injunctions, we recommend that the Commissioner of Internal Revenue:

- Develop clear and complete guidance for districts so that they know when and how shelter penalties are to be computed and follow up with districts after issuance to verify that the guidance is understood and correctly applied.
- Develop and implement district internal control procedures that require supervisory review of all penalties and a quality assurance review of selected penalties to ensure that appropriate penalties have been considered and accurately computed.
- Develop an effective program for monitoring enjoined parties' compliance with decrees and continue exploring opportunities to computerize monitoring when developing service center return identification criteria.

Agency Comments and Our Evaluation

In responding to a draft of this report, IRS, for the most part, disagreed with the recommendations contained in this chapter.

In responding to our recommendation to develop clear and complete guidance for districts on when and how to compute shelter penalties, IRS considered the present guidance to be adequate. However, IRS went on to explain that it is in the process of preparing for publication an updated guideline that will illustrate the computation of the section 6700 penalty when a person engages in multiple acts of organizing and selling abusive shelters. We believe such action would be responsive to our recommendation and should correct the deficiency noted in this report.

However, so that penalties are no longer overlooked, IRS' national office should follow up with the district offices to ensure that the updated guidance is understood. Since we believe that follow-up is essential to the success of IRS' initiative, we have amended our original recommendation to reflect the need for such action.

Regarding our recommendation to establish internal controls to ensure that all appropriate penalties are computed accurately, IRS said that sufficient internal control procedures now exist and pointed out that the cases are subject to review by a number of district organizations and must be approved by the district abusive tax shelter committee. However, IRS also said that it is taking additional steps to ensure that proposed penalties are properly assessed. Since IRS did not identify those steps, we followed up to determine what specific actions IRS plans to initiate; but, IRS officials were not able to tell us what specific steps they had planned.

We continue to believe that there is a need for improved internal control procedures because the controls that IRS says are sufficient were in place at the time of our review, but did not detect the problems we noted. The districts we reviewed did not have specific procedures designed for detecting and correcting the kinds of errors and oversights we found. Further, we found no national office procedures for exercising oversight to assure conformance to guidelines and consistency among districts. These are the kinds of internal controls that we had in mind.

Without timely implementation of effective internal control procedures, IRS runs the risk of overlooking or incorrectly computing abusive shelter penalties in the cases it examines. As of September 1987, IRS had 1,167 tax shelter penalty cases under examination.

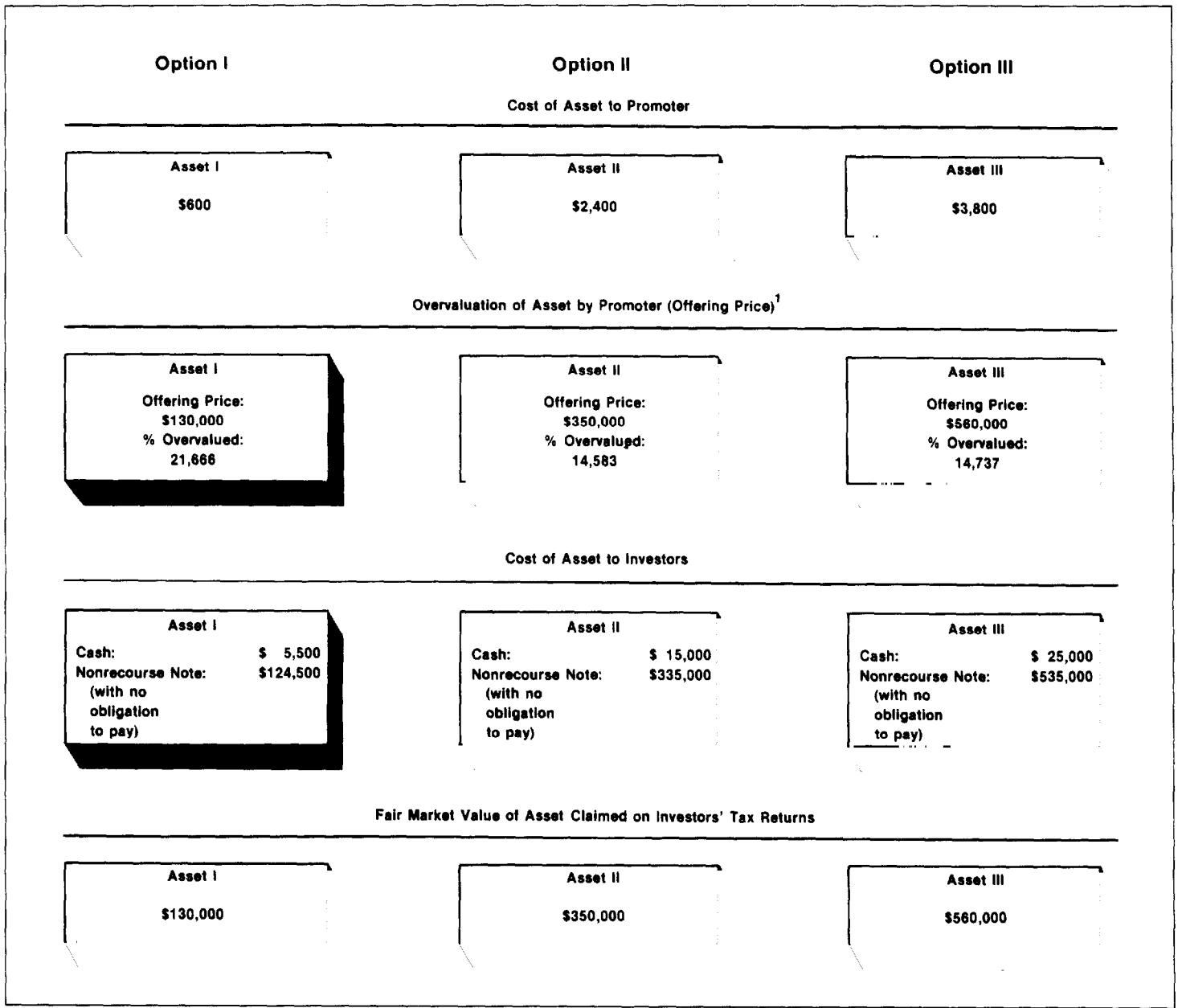
IRS said that it is considering methods that might be employed to monitor enjoined parties' compliance with the terms of injunctions. However, it does not anticipate that service center computer programs will need to be used due to the small number of injunctions and the nature of the limitations on subsequent activities. Our major concern is that IRS develop an effective system for monitoring enjoined parties' compliance. Therefore, since IRS is considering developing a monitoring system, we revised our recommendation to eliminate the requirement for computerization.

Concerning our recommendation to substantially increase the section 6700 penalty, IRS said it would have some administrative concerns about increasing penalties in the tax shelter area until an IRS Penalties Task Force completes its review of the current tax code penalties and the effect of certain penalties on taxpayer compliance and until the effects of TRA on tax shelters are known. Our review showed that although Congress increased the penalty from 10 to 20 percent of gross income derived from the promotion and sale of flagrantly overvalued shelters,

abusive shelters have continued to be marketed and promoters have been able to retain substantial amounts of money even after being penalized. Therefore, as long as IRS continues its efforts to identify and examine abusive tax shelters, we believe the penalty needs to be substantially increased to appropriately penalize those who promote such shelters and to effectively deter the future sale of abusive shelters.

IRS did not comment on our recommendation to reduce the level of proof in IRC section 6701 to assess the penalty for aiding and abetting in the understatement of tax liability.

Flowchart of One Type of Abusive Tax Shelter Offering Three Investor Options



[a]Promoter increases asset value without making improvements to product and establishes one or more organizations to buy and sell asset in order to inflate its value.

Sampling and Data Analysis Methodology

This appendix describes how we selected our sample and how we projected the sample data. Included in this appendix is a table showing the statistical sampling errors for the figures in the report.

Statistical sampling enables us to make estimates and draw conclusions about the universe of interest on the basis of information in a sample of that universe. Our particular sample is the universe of all registration forms received and processed by IRS as of March 1986.

Sample estimates are subject to sampling error. An estimate's sampling error measures the variability among the estimates obtained for all the possible samples. Sampling error is thus a measure of the precision or reliability with which an estimate from a particular sample approximates the results of a complete census. From the sample estimate, together with an estimate of its sampling error, interval estimates can be constructed with prescribed confidence that the interval includes the average result of all possible samples.

We randomly selected 500 registration forms from the universe of 23,487 registration forms filed with IRS. The simple random sampling technique allowed us to make estimates to the universe and all estimates are at a 95 percent confidence level. We calculated the sampling errors for estimates used in the report. Then, we calculated the lower and upper limits for the estimates. These limits are shown in table II.1.

Table II.1: Confidence Limits for Universe Estimates

Dollars in millions

		Confidence interval (95 percent)	
Description of universe estimates	**Universe estimates**	**Lower limit**	**Upper limit**
Potential late filing penalties based on IRS national office criteria for first 18 months	$48.6	$41.0	$56.3
for last 8 months	$18.3	$13.3	$23.5
		Cases	
District action on referred potentially abusive cases			
Examination was not initiated, shelter documents not obtained	2,443	1,592	3,294
Examination was completed, no abusiveness found	799	426	1,172
Examination still in progress	423	149	697
Cases transferred	94	2	224
Totals	**3,759**	**2,169**	**5,387**

Abusive Tax Shelter Examination Statistics for the Three Districts Reviewed for the Period September 1982 Through July 1986

Status of examination	Districts 1	2	3	Totals
Examinations initiated				
Promotions	74	47	46	167
Cases[a]	132	123	84	339
Examinations ongoing				
Promotions	20	26	28	74
Cases[a]	45	79	30	154
Examinations closed with penalties				
Promotions	15	5	8	28
Cases[a]	30	26	31	87
Examinations closed with injunction-no penalty				
Promotions	0	0	3	3
Cases[a]	0	0	9	9
Examinations closed-no penalty-no injunction				
Promotions	39	16	7	62
Cases[a]	57	18	14	89

[a]A case represents an individual or a firm associated with an abusive tax shelter promotion.
Source: Compiled by GAO from IRS records.

Abusive Tax Shelter Penalty Assessments and Collections for the Three Districts Reviewed for the Period September 1982 Through July 1986

Dollars in thousands

	Districts			
Penalty assessments	**1**	**2**	**3**	**Totals**
Section 6700	$1,356	$8,693	$7,548	**$17,597**
Section 6701	748	2,979	18,326	**22,053**
Section 6707	119	101	0	**220**
Section 6708	0[a]	0	0	**0[a]**
Totals	**$2,223**	**$11,773**	**$25,874**	**$39,870**
Total collections as of 12/31/86	$208	$1,555	$103	**$1,866**
Percent of total assessments	9.4	13.2	0.4	**4.7**

[a]Less than $1,000

Source: Compiled by GAO from IRS records.

Comments From the Commissoner of the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

FEB 4 1988

Mr. William J. Anderson
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

We have reviewed your recent draft report entitled "Tax Administration: IRS' Abusive Tax Shelter Efforts Need Improvement", and have enclosed detailed comments on the report recommendations.

As you know, the 1986 Tax Reform Act eliminated most incentives for investing in abusive tax shelters. Although the full impact on tax shelters will not be known for a few years, we believe that the Act will dramatically curtail the use of abusive tax shelters. Therefore, while the GAO report provides many useful comments and recommendations, we think it has been overtaken by intervening events, and that implementation of many of the recommended changes should be delayed pending analysis of the full impact of the Act on tax shelters.

We hope you find these comments useful.

With kind regards,

Sincerely,

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX ADMINISTRATION: IRS' ABUSIVE TAX SHELTER
EFFORTS NEED IMPROVEMENT"

Now on p. 20.

Recommendation 1 (Page 28): To improve the efficiency and effectiveness of the abusive shelter identification programs, we recommend that the Commissioner of Internal Revenue take the following actions:

a. Require organizers of registered shelters to provide the shelter prospectus and offering documents to their respective IRS district offices at the time of registration.

b. Require districts to review these documents in deciding whether to initiate an examination to determine if the shelter is abusive.

Response:

The Committee report for the Deficit Reduction Act of 1984 describes registration as "disclosure on a simple form" and "supplying information that briefly describes the investment". Based on these reports, we question whether the Service has the authority to require submission of prospectuses and/or offering materials as part of the registration process. In order to effectively implement the recommendation, we believe legislation would be needed (1) describing the documents required, (2) mandating their submission, and (3) providing penalties for failure to comply.

Because the definition of a tax shelter subject to registration is imprecise--it does not take into account income from the activity--many legitimate business enterprises are subject to registration. Requiring all entities subject to registration to prepare prospectuses and/or offering materials for submission to the Service will impose unwarranted legal and paperwork burdens on these legitimate businesses.

The proposed addition of this new requirement also raises the possibility that if the prospectuses are submitted and the Service does not audit the promotion, approval of the promotion may be implied. Presently, prospectuses are requested and reviewed by districts where registration applications contain indications of potential abuse.

Now on p. 21.

Recommendation 1 (Page 28): To improve the efficiency and effectiveness of the abusive shelter identification programs, we recommend that the Commissioner of Internal Revenue take the following actions:

c. Develop and periodically update national selection criteria that can be used by IRS service center detection teams and district examination personnel to identify the tax shelter returns most likely to contain a gross overvaluation of an asset or false or fraudulent statement.

d. Maximize the use of computers to identify and thus reduce cases for detection team review.

Response:

We agree in principle with the GAO recommendation regarding improved selection criteria and computer usage. This course of action was recommended prior to the GAO report by an IRS task force chaired by the Assistant Regional Commissioner (Criminal Investigation), Mid-Atlantic Region and the Assistant Regional Commissioner (Examination), Central Region. However, the GAO report bases this recommendation on the premise that these courses of action have not previously been pursued and that the Abusive Tax Shelter Detection Teams (ATSDTs) have not been successful. This is not accurate.

The computer selection criteria utilized by the ATSDTs has been modified each year since the inception of the teams, based on reviews conducted by the National Office and regions and on the experiences of the individual ATSDTs. In addition, in certain situations, it was not feasible to use computerized criteria for identification as other processing priorities precluded this.

The GAO review also failed to consider a number of other factors that had a significant impact on the ability of ATSDTs to identify abusive tax shelter returns and on the rate of acceptance by district offices. For example, the GAO report states that ATSDT personnel and district personnel did not use the same criteria when they reviewed tax returns and other documents for issues of abusiveness. This is true but for good reason. ATSDTs are located in service centers and are staffed mainly by tax examiners, with a revenue agent and/or special agent available for technical advice. As such, they have limited access to information that is a definitive indication of an abusive tax shelter. Therefore, their function is to uncover initial indications of fraudulent shelters for possible further development by district offices. In contrast, district offices have access to far more information (e.g., shelter prospectuses)

from which to draw conclusions regarding abuse. In addition, they have available the combined expertise of not only Examination and Criminal Investigation but Chief Counsel attorneys as well. The final determination of abusiveness is based upon an examination of a particular promotion by a revenue agent. Considering these factors, there is no way the districts and service centers could share a common criteria, since the criteria for an indication of fraud is far less than that for proving it.

Another point not considered by GAO is the need for some geographical flexibility. The GAO report assumes that abuse is measured only in terms of monetary loss to the government. In fact, the magnitude of the shelter in terms of the number of investors or potential investors can be of equal or greater importance, as it can have a more deleterious effect on voluntary compliance.

Further, we question GAO's assessment that the ATSDT program has not produced shelter cases that are potentially abusive. We believe the scope of their audit was insufficient to make such a determination, and that the findings of the aforementioned IRS task force are a better indication of the success achieved by the ATSDTs. A copy of the task force's report has been provided to GAO.

Now on p. 36.

Recommendation 3 (Page 42): To ensure that penalties are assessed when appropriate and computed correctly, and that enjoined parties comply with the terms of the injunctions, we recommend that the Commissioner of Internal Revenue:

a. Develop clear and complete guidance for districts so that they know when and how shelter penalties are to be computed.

Response:

We feel that the instructions provided in the Law Enforcement Manual (LEM) are basically adequate. Contrary to the draft GAO report, the Law Enforcement Manual states that "organization" under section 6700(a)(1)(A) constitutes an "activity" subject to penalty, and (2) multiple activities are taken into account when calculating the section 6700 penalty. Moreover, the Law Enforcement Manual provides examples illustrating how to compute the penalty when multiple sales are involved. We are preparing for publication an updated guideline which illustrates the computation of the 6700 penalty when a person engages in multiple acts of organizing and selling abusive tax shelters.

Now on p. 36.

Recommendation 3 (Page 42): To ensure that penalties are assessed when appropriate and computed correctly, and that enjoined parties comply with the terms of the injunctions, we recommend that the Commissioner of Internal Revenue:

b. Develop and implement district internal control procedures that require supervisory review of all penalties to ensure that appropriate penalties have been considered and accurately computed. These procedures should require quality review of penalties, at least on a selected basis.

Response:

We believe sufficient control procedures now exist, since abusive tax shelter penalty cases are subject to review by members of the Examination Division, Criminal Investigation Division, and District Counsel. Every case must be approved by the Abusive Tax Shelter Committee and, in some cases, by the district director. We are, however, taking additional steps to ensure that proposed penalties are properly assessed.

Now on p. 36.

Recommendation 3 (Page 42): To ensure that penalties are assessed when appropriate and computed correctly, and that enjoined parties comply with the terms of the injunctions, we recommend that the Commissioner of Internal Revenue:

c. Develop service center computer programs to monitor how enjoined parties comply with decrees.

Response:

We are considering methods which might be successfully employed to monitor compliance with injunctions. We do not anticipate that service center computer programs will be used to monitor subsequent actions of abusive promoters due to the small number of injunctions and the nature of the limitations on subsequent activities.

See p. 35.

Recommendation to Congress: To reduce the financial incentive for promoting abusive tax shelters, we recommend that Congress enact legislation to modify IRC Section 6700 to significantly increase the penalty above the current 20 percent of gross income derived, or to be derived, by any party involved with the promotion or sale of an abusive shelter.

Response:

Currently, the Internal Revenue Service has a Penalties Task Force which is reviewing the current tax code penalties and the effect of certain penalty provisions on taxpayer compliance. Until the Task Force completes its review and the effects of the Tax Reform Act of 1986 are known, the Internal Revenue Service will have some administrative concerns related to proposals to increase penalties in this area.

*U.S. G.P.O. 1988-201-749:80196

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